

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:HOU:TL-N-2477-99
TLFenner

date: AUG 12 1999

to: Chief, Appeals Division, Houston

from: District Counsel, Houston

subject: [REDACTED]

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At the request of Revenue Agent Sylvia Schooler, we have reviewed the revenue agent's report for the examination of [REDACTED] for the tax years [REDACTED] and [REDACTED] and the taxpayer's protest letter dated [REDACTED] [sic, [REDACTED]]. We did not have the administrative files available to us during our review; the scope of our analysis was limited accordingly. We did not receive the portion of the report covering the penalties, and therefore we express no opinion on the assertion of penalties. The case is assigned to Appeals Officer Bill Johnson in your office.

ABANDONED ACQUISITION COSTS EXPENSE

Facts.

[REDACTED] is an international [REDACTED] and [REDACTED] company engaged primarily in the exploration and development of [REDACTED] and [REDACTED]. [REDACTED] also transports and distributes [REDACTED] in [REDACTED] through a division and wholly-owned subsidiary called [REDACTED].

In [REDACTED] of [REDACTED], [REDACTED]'s board of directors approved a plan to create and issue a new class of common stock (the [REDACTED] Stock) intended to reflect separately [REDACTED]'s performance and to provide holders with financial returns based on [REDACTED]'s performance (the [REDACTED] Stock Plan). [REDACTED] would attempt to attain those objectives through its dividend practices and policies. Dividends on the [REDACTED] Stock would be paid at the discretion of the board based primarily on the financial condition, results of operations, and business requirements of [REDACTED] and, to a lesser extent, [REDACTED] as a whole. Net proceeds from the [REDACTED] Stock Plan would be used to repay debt not attributable to [REDACTED].

[REDACTED] paid [REDACTED] and others \$[REDACTED] in connection with the [REDACTED] Stock Plan. We have not seen the compensation agreements with [REDACTED] and the others, but it appears that the \$[REDACTED] was paid solely in connection with obtaining shareholder approval to create the new class of common stock.¹ [REDACTED] obtained shareholder approval for the [REDACTED] Stock Plan, but apparently because of unfavorable market conditions in the second half of [REDACTED], the [REDACTED] Stock was not issued. On its federal income tax return for the tax year [REDACTED], [REDACTED] deducted the \$[REDACTED] paid in connection with the [REDACTED] Stock Plan as "abandoned acquisition costs." The revenue agent disallowed the entire deduction.

It was always an integral part of the [REDACTED] Stock Plan that issuance of the [REDACTED] Stock, even after obtaining shareholder approval, was contingent upon market conditions.² In its proxy

¹ In the section of its [REDACTED] annual report entitled "[REDACTED] Results Compared to [REDACTED]," [REDACTED] reported, "[REDACTED]

[REDACTED]")." Again in the notes to the annual report, [REDACTED] reported, "[REDACTED]

² In [REDACTED]'s [REDACTED] annual report, the company reported:

statement soliciting shareholder approval of the [REDACTED] Stock Plan, [REDACTED] made clear that even if the plan was approved, [REDACTED] would continue to monitor market conditions and to consider other options.³ On [REDACTED], [REDACTED] reported that the shareholders had approved the [REDACTED] Stock Plan, and it could proceed at any time with the stock offering, but it would not proceed with issuing the [REDACTED] Stock until market conditions improved.⁴

[REDACTED]

³ In the Proxy Statement filed with the SEC on [REDACTED], [REDACTED] stated:

[REDACTED]

⁴ Note [REDACTED] of the Form 10-Q filed with the SEC on that date stated:

On [REDACTED], shareholders approved a plan (the

"[REDACTED]"

[REDACTED]

On [REDACTED], [REDACTED] expressed its intention to expense in [REDACTED] the \$ [REDACTED] in fees paid in connection with the [REDACTED] Stock Plan if it did not proceed with the stock offering by the end of [REDACTED], but [REDACTED] did not indicate it would altogether abandon the plan to issue the [REDACTED] Stock.⁵ In its [REDACTED] annual report, [REDACTED] again acknowledged that it was "authorized to proceed at any time with a public offering" of the [REDACTED] Stock and that it "continues to monitor current conditions." The report also explained again the changes that would take place on shareholder's equity after the stock was offered.⁶ In his letter to shareholders in the [REDACTED] annual

⁵ Note [REDACTED] of the Form 10-Q filed with the SEC that date stated:

⁶ Note [REDACTED] to the annual report states:

report, the chairman of the board of [REDACTED] stated that plans to issue the [REDACTED] Stock had been deferred:

[REDACTED]

Even a year later, in the Form 10-K filed with the SEC on [REDACTED], [REDACTED] described the \$[REDACTED] as the cost of obtaining shareholder approval to create the [REDACTED] Stock. [REDACTED] did not state that the plan to issue the stock had been abandoned, only that none of the stock had yet been issued.⁷

On page 2 of the Protest, [REDACTED] states, "Significantly, [REDACTED]'s Board of Directors never authorized the amendment of [REDACTED]'s Articles of Incorporation, a condition precedent to the proposed stock offering." We do not believe the delay in amending the articles of incorporation is evidence of an abandonment. [REDACTED] did not intend to file the amendments until immediately before the stock offering, and the stock offering was deferred.⁸

[REDACTED]

7 [REDACTED]

[REDACTED]

⁸ In the proxy statement soliciting shareholder approval of the [REDACTED] Stock Plan, [REDACTED] stated:

[REDACTED]

In the same paragraph on page 2 of the Protest, [REDACTED] states, "In [REDACTED], [REDACTED]'s Board of Directors abandoned the proposed stock issuance plan in favor of pursuing an outright sale of its [REDACTED] operations." [REDACTED] makes the same statement on page [REDACTED] of the Protest. In [REDACTED] the board of directors considered selling [REDACTED] as an alternative to issuing the [REDACTED] Stock, but the board decided not to pursue a sale of [REDACTED]. The minutes say nothing about the plan to issue the [REDACTED] Stock.⁹ [REDACTED]'s statement that the board had abandoned the plan is contrary to the chairman's statement to shareholders in the [REDACTED] annual report that the stock offering had only been "deferred." Moreover, in the proxy statement soliciting shareholder approval of the [REDACTED] Stock [REDACTED], [REDACTED] explicitly stated its intention to continue considering other alternatives. We fail to see how [REDACTED]'s consideration of other alternatives, as expressly contemplated in the [REDACTED] Stock Plan, is evidence of an abandonment of that plan.

The Protest also states on page [REDACTED] that the RAR incorrectly emphasizes the significance of shareholder approval of the [REDACTED] Stock Plan, because there were other conditions to be met before a public offering, such as amendment of the articles of incorporation. We believe the issue is properly focused on shareholder approval, because it appears that the \$[REDACTED] was paid to obtain that approval. [REDACTED] got what it paid for: shareholder approval to issue a new class of common stock.

At the bottom of page [REDACTED] of the Protest, [REDACTED] claims that the revenue agent's statement that "subject to certain conditions, [REDACTED] was authorized to proceed at any time" with the [REDACTED] Stock Plan is incorrect and misleading, because the language implies that only ministerial acts remained. The revenue agent's language is taken verbatim from several of

[REDACTED]

⁹ The minutes attached to the Protest from the board's meeting on [REDACTED] state, "[REDACTED]

[REDACTED]

[REDACTED]

An income tax deduction is a matter of legislative grace and the burden of showing the right to the claimed deduction is on the taxpayer. New Colonial Ice v. Helvering, 292 U.S. 435, 440 (1934). The notion that deductions are exceptions to the norm of capitalization finds support in various aspects of the Code. Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. See I.R.C. §§ 161 and 261. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a complete list of nondeductible expenditures, section 263 serves as a general means of distinguishing capital expenditures from current expenses. Idaho Power, 418 U.S. at 16. For these reasons, deductions are strictly construed and allowed only as there is a clear provision for allowance. New Colonial Ice, 292 U.S. at 440.

██████ states that it does not dispute that the \$ ██████ in fees are not deductible as ordinary and necessary business expenses under section 162(a). Rather, ██████ claims the costs were capital in nature which became deductible under section 165 when the ██████ Stock Plan allegedly was abandoned in ██████

Under section 165(a) of the Code, a taxpayer may take a deduction for any loss sustained during the tax year which is not compensated for by insurance or otherwise. Section 165 generally provides that in order to be entitled to an abandonment loss, a taxpayer must demonstrate an intention to abandon the asset as well as an affirmative act of abandonment. United States v. S.S. White Dental Manufacturing, 274 U.S. 398 (1927). The mere intention alone to abandon is not, nor is non-use alone, sufficient to accomplish abandonment. Beus v. Commissioner, 261 F.2d 176, 180 (9th Cir. 1958), aff'd 28 T.C. 1133 (1957).

In determining a taxpayer's intent to abandon, the subjective judgment of the taxpayer as to whether the business assets will in the future have value is entitled to great weight and a court is not justified in substituting its business judgment for a reasonable, well-founded judgment of the taxpayer. A.J. Industries v. United States, 503 F.2d 660, 670 (9th Cir. 1974). Tangible property is capable of physical abandonment, but abandonment of intangible property interests should be accomplished by some express manifestation. Citron v. Commissioner, 97 T.C. 200, 209 (1991). An affirmative act to abandon must be ascertained from all the facts and surrounding circumstances. United California Bank v. Commissioner, 41 T.C. 437, 451 (1964), aff'd. per curiam, 340 F.2d 320 (9th Cir. 1965). Courts will look beyond the taxpayer's formal characterization. Laport v. Commissioner, 671 F.2d 1028, 1032 (7th Cir. 1982).

█████ cites legal authority for the rule that capitalized costs in connection with proposed corporate reorganizations become deductible when the proposed plans for reorganization are abandoned. That authority does not aid █████, because we do not believe there was an abandonment in █████. Resolution of the issue in this case will turn primarily on the factual question of whether and when █████ made the final decision to abandon the █████ Stock Plan.

In Revenue Ruling 67-125, 1967-1 C.B. 31, the Service ruled that the legal fees a corporation incurred in connection with a proposed corporate reorganization were not deductible under section 162. █████ points to the final sentence of that ruling in support of its position: "However, in the event the proposed redemption of stock is subsequently abandoned, the capitalized fees attributable to such proposed redemption are deductible in the taxable year of abandonment." The ruling does not aid █████, however, because the ruling distinguished between a tentative abandonment and a final decision to abandon:

Since these conditions did not materialize, the planned redemption was tentatively abandoned for the year of the merger and the stock split. However, no final decision has been made as to whether the redemption will be made or finally abandoned. . . .

However, if the taxpayer can subsequently establish that it has made a final decision not to carry out the redemption, the costs attributable to the proposed redemption may be deducted in the taxable year in which such a decision was made.

1967-1 C.B. 31-32 (emphasis added).

In Revenue Ruling 73-580, 1973-2 C.B. 86, the Service ruled that compensation paid to a corporation's employees in connection with corporate mergers and acquisitions must be capitalized. The Service noted in the ruling that "[i]f the plan of reorganization is abandoned, the expenditures related to the proposed plan are deductible in the year it is abandoned."

In Revenue Ruling 79-2, 1979-1 C.B. 98, the shareholders of a privately owned corporation incurred fees preparatory to making a public offering of the corporation's stock. The public offering was scheduled to take place on May 1, 1976, but the offering was abandoned in May because of unfavorable market conditions. The Service concluded that the costs incurred by the shareholders were deductible under section 165 in 1976, but it was a given fact in the ruling that "[t]he product of all the

expenses incurred in preparation for the offering was totally without residual value on December 31, 1976, and thereafter." The same cannot be said of the \$ [REDACTED] paid by [REDACTED]. [REDACTED] apparently did not have a target date for the [REDACTED] stock offering, it continued to monitor market conditions, the planned offering was only deferred, and the expenses were not totally without residual value, because [REDACTED] incurred the fees to obtain shareholder approval to create the new class of stock, and that approval was obtained.

In Doernbecher Manufacturing Co. v. Commissioner, 30 B.T.A. 973, 982 (1934), acq., 1934-2 C.B. 6, and aff'd, 80 F.2d 573 (9th Cir. 1935), the corporation was one of several companies considering a merger. The companies collectively formed a committee and paid fees to study the proposed merger. The committee advised the taxpayer that the proposed merger had been abandoned, and the court allowed a deduction for the corporation's share of the fees. The case is inapposite to [REDACTED]'s case, because in Doernbecher there was no question that there had been an abandonment in the year at issue.

[REDACTED] argues that Sibley v. Commissioner, 15 T.C. 106 (1950), acq., 1951-1 C.B. 3, is controlling here. In Sibley, the corporation paid Goldman, Sachs and Company \$15,000 to study its entire capital structure. Goldman made three recommendations. The taxpayer adopted one of the proposals, but rejected two of them, and claimed a deduction for the entire fee paid to Goldman. Citing Doernbecher, the court held that the taxpayer could deduct \$10,000 of the Goldman fee, because two-thirds of Goldman's recommendations had been abandoned.

We do not believe Sibley is controlling, because there was no dispute in Sibley with regard to if or when the corporation had abandoned two of the proposed plans. In its findings of fact, the court said, "At this meeting it was decided that petitioner, because of the advice of counsel, would be compelled to abandon two of the projects recommended by Goldman. . . ."

[REDACTED] points to the following three events as the identifiable events fixing [REDACTED] as the year of the abandonment:

- (1) the board's alleged decision to abandon the [REDACTED] Stock Plan in favor of another plan;
- (2) unfavorable economic conditions; and
- (3) the determination by [REDACTED]'s outside auditors to write-off the \$ [REDACTED] in [REDACTED]

The minutes of the board's meetings attached to the Protest do not indicate that the board made a final decision to abandon the [REDACTED] Stock Plan in [REDACTED]. In his letter to shareholders with the [REDACTED] annual report, the chairman of the board said that the plan had only been deferred. Moreover, unfavorable economic conditions are not an identifiable event or an affirmative act of abandonment.

We do not know what specific considerations went into the financial auditors' decision to write-off the \$ [REDACTED] in fees in [REDACTED], but the treatment of the item for financial accounting purposes is not persuasive evidence of its deductibility for tax purposes. There is no presumptive equivalency between tax and financial accounting, especially in situations such as this, in which the taxpayer is attempting to deduct currently an expenditure which benefits future periods. Thor Power Tool v. Commissioner, 439 U.S. 522 (1979). The primary goal of the income tax system is the equitable collection of revenue. Id. The primary goal of financial accounting, in contrast, is to provide useful information to management, shareholders, and others; and the accountant's responsibility is to protect those parties from being misled. Id. Consistent with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that possible errors in measurement should be in the direction of understatement rather than overstatement of net income and net assets." Id.

In conclusion, based on our review of the revenue agent's report, the Protest, and [REDACTED]'s SEC filings published on LEXIS, we do not believe [REDACTED] demonstrated either an intention to abandon the [REDACTED] Stock Plan or an affirmative act of abandonment in [REDACTED]. The chairman of the board's letter to shareholders in the [REDACTED] annual report, in which he stated that the plan had only been "deferred," is persuasive evidence that [REDACTED] had not abandoned the plan. The statement in the [REDACTED] annual report that the [REDACTED] Stock had been authorized but not issued as of the end of [REDACTED] and [REDACTED], coupled with the absence in the report of any indication that the plan had been abandoned, is also inconsistent with an intent to abandon the plan. The minutes of the board meetings to which [REDACTED] points as evidence of abandonment simply are not persuasive.

WORKFORCE REDUCTION AND RESTRUCTURING EXPENSE**Facts.**

[REDACTED] established an office in [REDACTED] Texas in [REDACTED] when it acquired certain assets from [REDACTED] for \$[REDACTED]. [REDACTED] established an office in [REDACTED], Louisiana in [REDACTED] when it acquired all the stock of [REDACTED]. In [REDACTED] [REDACTED] deducted \$[REDACTED] in general and administrative expenses relating to its decision to close its [REDACTED] and [REDACTED] offices (the Office Closing Costs). The chairman of [REDACTED]'s board of directors estimated that the closings would save [REDACTED] \$[REDACTED] annually.

Of the \$[REDACTED] deducted by [REDACTED] in [REDACTED], \$[REDACTED] was actually paid in [REDACTED], \$[REDACTED] was paid in [REDACTED] and \$[REDACTED] either was not paid or was paid after [REDACTED]. The Office Closing Costs were comprised of the following items:

Severance compensation	\$
Relocation costs	\$
Recruiting expenses	
Office relocation costs	
Lease termination costs	\$
Transition costs	
Other	

[REDACTED]

The revenue agent proposed to disallow the entire amount as a nondeductible capital expenditure.

Analysis.

Sections 162 and 263 of the Code together with their related regulations provide the statutory and regulatory framework for analyzing severance payments. Section 263(a) provides that the cost of permanent improvements or betterments made to increase the value of any property or estate must be capitalized. Section 162(a) of the Code provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation. Treasury Regulation section 1.162-10(a) states that amounts "paid or accrued within the taxable year for dismissal wages . . . are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business."

Section 161 of the Code clarifies the relationship between deductions allowable under section 162 and capital expenditures under section 263. Section 161 provides that the deductions allowed in Part VI, including section 162, are subject to the exceptions set forth in Part IX, including section 263. The capitalization rules of section 263 therefore take precedence over the rules for deductions under section 162. See Commissioner v. Idaho Power Co., 418 U.S. 1 (1974).

In describing the interplay between section 162 and section 263, the Supreme Court noted in Indopco, Inc. v. Commissioner, 503 U.S. 79, 84 (1992), that deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. Expenditures that are required to be capitalized are not exhaustively enumerated in the Code. Id. The Court stated that the determination of whether an expenditure is currently deductible or should be capitalized requires "an inquiry into the duration and extent of the benefits realized by the taxpayer." Id. at 88.

The Code and regulations specifically enumerate compensation such as severance pay as a business expense that is currently deductible under section 162. In Revenue Ruling 94-77, 1994-2 C.B. 19, the Service determined that Indopco did not affect the treatment of severance payments as business expenses that are generally deductible under section 162 and section 1.162-10. In the ruling, the Service explained:

[A]lthough severance payments made by a taxpayer to its employees in connection with a business down-sizing may produce some future benefits, such as reducing operating costs and increasing operating efficiencies, these payments principally relate to previously rendered services of those employees. Therefore, such severance payments are generally deductible as business expenses under § 162 and § 1.162-10.

In the instant case, the revenue agent believes the severance payments incurred by [REDACTED] should be capitalized because the payments provided a significant benefit into the indeterminate future. Because the revenue agent did not believe [REDACTED] adequately responded to all of her requests for information, the revenue agent assumed that the Office Closing Costs saved \$ [REDACTED] annually, a significant savings. The revenue agent's inquiry into the duration of the benefits provided by the Office Closing Costs is an analysis like that made by the Supreme Court in Indopco. Even in the presence of such significant future savings, we do not believe Revenue Ruling 94-77 allows such an inquiry with respect to the severance

payments. The information available to us indicates that, like the severance payments in the revenue ruling, the severance payments incurred by [REDACTED] "principally relate to previously rendered services of those employees."

Relying on the origin of the claim doctrine, the revenue agent believes the Office Closing Costs incurred by [REDACTED] should be capitalized as part of the [REDACTED] and [REDACTED] asset acquisitions, because the costs had their origin in those acquisitions. The revenue agent argues that "but for" the asset acquisitions, [REDACTED] would not have incurred the costs. Revenue Ruling 94-77 does not address the federal income tax treatment of severance payments made as part of the acquisition of property.

The origin of the claim doctrine was first articulated by the Supreme Court in United States v. Gilmore, 372 U.S. 39 (1963). In Gilmore, the Court held that to determine the deductibility of litigation costs, one must look to the origin and character of the claim underlying the expense incurred. Id. at 49 ("The origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense . . . is deductible."). The object of the origin of the claim test is to find the transaction or activity from which the taxable event proximately resulted. Id. at 39.

Private letter rulings have no precedential value, but in Private Letter Ruling 9731001, the Service ruled that the origin of the claim doctrine does not preclude the deduction of severance payments made after a corporate acquisition. In the private letter ruling, the severance payments had an even closer nexus to the corporate acquisition than apparently is present in [REDACTED]'s case. In the private letter ruling, after the taxpayer and the target corporation agreed to a price to be paid for all the stock of the target, the taxpayer and the target corporation negotiated over other terms and conditions of the transaction, including severance pay. Two years later, the taxpayer incurred severance pay expenses under the agreement. In ruling that the severance pay was currently deductible, the Service concluded:

Although it is clear that the increase in severance payments was coincidental to the acquisition and merger and was motivated by Taxpayer's desire that the merged business operations integrate successfully, the additional severance payments in this case have their origin in Taxpayer's post-acquisition employment relationship with its employees.

The revenue agent cites Frankford-Quaker Grocery Co. v. United States, 353 F.Supp. 93 (E.D. Pa. 1972), in support of her argument that [REDACTED]'s severance payments were made to acquire employee goodwill and therefore are not currently deductible. In Frankford-Quaker, two cooperatives of retail grocers agreed to combine their businesses. Id. at 96. As part of the agreement, Frankford-Quaker agreed to make certain payments to employees of Penn Mutual who lost their jobs as a result of the combination. Id. at 100. Frankford-Quaker made the payments within 6 months of the business combination. Id. The district court held that the payments were not currently deductible, because in making the payments Frankford-Quaker acquired employee goodwill, "a belief by the Penn Mutual employees who were joining Frankford-Quaker that the new company had some paternalistic instincts." Id. The district court held that, like the cost of customer goodwill acquired in business combinations, the cost of employee goodwill is not deductible. Id. In short, the court determined that the payments were not deductible, because they were made as part of the business combination.

Neither the revenue agent's report nor [REDACTED]'s protest indicates that the severance payments were made as part of the agreements to acquire the [REDACTED] and [REDACTED] assets. Private Letter Ruling 9731001 and Frankford-Quaker both require a very close nexus between the asset acquisition and the severance payments before the severance payments must be capitalized as part of the purchase price. The severance payments in the private letter ruling were made within 2 years of the merger pursuant to an agreement incident to the merger. In Frankford-Quaker, the payments were made within 6 months of the merger, pursuant to the merger agreement. [REDACTED] made the severance payments 3 or 4 years after the asset acquisitions, and the revenue agent's report does not state that the payments were made pursuant to the purchase agreements.

The revenue agent suggests in her report that [REDACTED] paid some or all of the Office Closing Costs to discharge liabilities [REDACTED] assumed as part of the [REDACTED] and [REDACTED] acquisitions. If true, of course we would agree that the payments are not deductible. But neither the revenue agent's report nor [REDACTED]'s protest contains a description of facts sufficient to support such an argument.

The revenue agent argues that the closing of the [REDACTED] and [REDACTED] offices was a corporate restructuring. She correctly notes that costs incurred incident to a corporate reorganization, recapitalization or acquisition by another entity should be capitalized. After a very thorough analysis of Indopco and related judicial authority, she concludes that the Office

Closing Costs should be capitalized because they significantly benefit future operations. We have been unable to find any case in which a court held that the closing of certain offices was a restructuring requiring the capitalization of the related costs. As explained below, based on our review of the relevant case law, we do not believe a court would extend Indopco to the Office Closing Costs incurred by [REDACTED].

With respect to amounts paid by [REDACTED] to terminate leases in connection with the office closings, Revenue Ruling 69-511, 1969-2 C.B. 23, generally allows a deduction for such payments. Even before that revenue ruling was issued, however, courts allowed taxpayers to currently deduct amounts paid to terminate burdensome and uneconomic contracts.¹⁰ In addition, both the courts and the Service have consistently maintained that amounts paid solely to reduce or eliminate future costs are deductible.¹¹

Under certain unique circumstances, courts have required taxpayers to capitalize amounts paid or incurred in connection with the termination of unprofitable contracts. For example, in Darlington-Hartsville Coca-Cola Bottling Co. v. United States, 273 F.Supp. 229 (D. S.C. 1967), aff'd, 393 F.2d 494 (4th Cir.), cert. denied, 393 U.S. 962 (1968), the taxpayer reimbursed Coca-Cola for the cost of removing a middleman in exchange for

¹⁰ See, e.g., Capitol Indemnity Ins. Co. v. Commissioner, 237 F.2d 901, 903 (7th Cir. 1956) (allowing deduction for amounts incurred by taxpayer to free itself from an unprofitable agency contract); Montana Power Co. v. United States, 171 F.Supp. 943 (Ct. Cl. 1959) (allowing deduction for cash paid and the fair market value of stock surrendered to relieve the taxpayer of its obligation under supply contract); Stuart Co. v. Commissioner, 9 T.C.M. (CCH) 585 (1950), aff'd, 195 F.2d 176 (9th Cir. 1952) (allowing deduction for amount paid for cancellation of an onerous supply contract); Olympia Harbor Lumber Co. v. Commissioner, 30 B.T.A. 114 (1934), acq., 1934-1 C.B. 12, and aff'd, 79 F.2d 394 (9th Cir. 1935) (allowing deduction for amount paid to terminate an unsatisfactory waste disposal contract).

¹¹ See, e.g., T.J. Enterprises, Inc. v. Commissioner, 101 T.C. 581, 589 (1993) (allowing deduction for amounts paid to majority shareholder to compensate her for refraining from causing a royalty rate increase); Rev. Rul. 95-32, 1995-1 C.B. 8 (allowing current deduction for expenditures incurred by a public utility for the implementation and operation of energy load management programs); Rev. Rul. 94-77, 1994-2 C.B. 19 (allowing deduction for severance payments notwithstanding Supreme Court's decision in Indopco).

new contracts to obtain Coca-Cola syrup directly at more favorable prices. The court noted the general rule that an expenditure is a capital outlay, as opposed to an ordinary and necessary business expense, if it brings about the acquisition of a business advantage extending into the indefinite future. 273 F.Supp. at 231. The court concluded that the payments were capital expenditures, not deductible business expenses, because they obtained for the taxpayer an intangible business advantage of an indefinite duration. Id. Similarly, in Rodeway Inns of America v. Commissioner, 63 T.C. 414 (1974), acq., 1975-2 C.B. 2, the court held that a taxpayer's payment to cancel a territorial franchise agreement was a capital expenditure because the costs were incurred to acquire the unrestricted right to conduct business and derive profits over future years.

More recently, in U.S. Bancorp & Consol. Subsidiaries v. Commissioner, 111 T.C. 231 (1998), the Tax Court held that the charge incurred by a taxpayer lessee in terminating a lease of a mainframe computer was not a currently deductible expense where the taxpayer simultaneously initiated a new lease of a more powerful mainframe computer with the same lessor. The court noted that the lease cancellation cases illustrate two ends of a spectrum:

At one end is the case where a lessee pays a lessor to terminate a lease and no subsequent lease is entered into between the parties. In such a case the termination fee is clearly deductible in the year incurred, as there is no second lease raising the possibility that the lessee will realize significant future benefits beyond the taxable year as a result of the termination payment. At the opposite end is the case of a lessee that cancels a lease and then immediately enters into another lease with the same lessor, covering the same property. In substance, the first lease is not canceled but continues in modified form, and any unrecovered costs of the first lease, or costs incurred to cancel the first lease, are not currently deductible but rather are costs of continuing the first lease in modified form.

111 T.C. at 239 (emphasis added).

The court in U.S. Bancorp concluded that the taxpayer's situation was more similar to a modification. Specifically, the court was persuaded by the "integrated nature of the agreements and transactions by which the first lease was terminated and the second lease was entered." Id. at 239-40. The court emphasized that the termination of the first lease was expressly conditioned

on the taxpayer's initiation of a new lease with the same lessor, that the parties to the transaction were identical, and that the properties covered by the two leases were similar. Id. at 240. The court reasoned that the charge should not be viewed as an isolated fee for terminating the first lease, but as a cost of entering into a new lease. Id. Accordingly, the court concluded that the taxpayer's obligation to pay the fee was a capital expenditure amortizable over the new lease term. Id. at 242.

Neither the revenue agent nor [REDACTED] in its protest cited U.S. Bancorp, but we believe the court's analysis there is controlling with respect to the costs incurred by [REDACTED] to terminate its leases. Based on the information available to us, we believe the Office Closing Costs paid by [REDACTED] were more in the nature of deductible severance pay and lease termination costs than capital expenditures under section 263. The payments will reduce future costs to [REDACTED], but as discussed above, amounts paid to terminate burdensome contracts and to reduce or eliminate future costs, without more, are generally considered ordinary and necessary business expenses under section 162. Notes 10 and 11, supra.

Unlike U.S. Bancorp, no part of the revenue agent's report or [REDACTED]'s protest suggests that the Office Closing Costs should be viewed as a cost of entering into new lease agreements or other contracts. The Office Closing Costs were not conditioned upon [REDACTED] entering any new agreements. Furthermore, unlike the taxpayers in Darlington-Hartsville and Rodeway Inns, it does not appear that [REDACTED] obtained any significant future benefits other than relief from its uneconomic leases and other contracts associated with the office closings. [REDACTED]'s payments did not secure any additional business advantage or right.


The Tax Court recently considered the Indopco doctrine again in Norwest Corporation v. Commissioner, 112 T.C. 89 (1999). Norwest, a bank holding company, acquired all the stock of Davenport Bank, a regional state bank in Iowa. Prior to the acquisition, Davenport Bank incurred costs to investigate whether the acquisition would be a good idea. Norwest, Davenport's successor in interest, argued in the Tax Court that such investigatory costs should be currently deductible, because they were incurred before the board of directors approved the purchase. The court held that the expenditures should be capitalized, because they were sufficiently related to the acquisition. The court said, "In accordance with Indopco, the costs must be capitalized because they are connected to an event (namely, the transaction) that produced a significant long-term benefit." 112 T.C. at 100. Norwest does not apply to [REDACTED]'s

Office Closing Costs because those costs were more related to past services rendered by employees and the termination of leases already in force than to the production of significant long-term benefit.

In summary, we believe that Revenue Ruling 69-511 and the court's analysis in U.S. Bancorp allow a current deduction for the lease termination and related costs incurred by [REDACTED]. The severance compensation and related costs incurred by [REDACTED] are deductible under Revenue Ruling 94-77. We note that a portion of the costs incurred by [REDACTED] were not actually paid in [REDACTED]. Without more information regarding the specific costs incurred by [REDACTED], we cannot express an opinion on whether all the costs satisfied the all-events test of I.R.C. § 461 in 1995.

Please call me at (281) 721-7309 if you have any questions.

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